

# THE EXPANDING REACH OF THE ALTERNATIVE MINIMUM TAX

By Clark M. Blackman II and Ellen J. Boling

Ostensibly created as a means of keeping the rich from living tax-free, the alternative minimum tax is casting an ever-widening net each year as more taxpayers become subject to it.

Think back to an earlier time in your life when you were younger and probably poorer than you are now. The idea of the “rich” being able to get away with paying little or no taxes probably elevated your blood pressure every April 15 as you wrote your check to the IRS. The collective outrage of millions like you led to the creation of the alternative minimum tax (AMT) in 1978. The alternative minimum tax was created to keep the “Fat Cats” from using tax reduction strategies to reduce their taxes to next to nothing.

Flash forward to the year 2002. You are now making more money than you ever thought possible. Yet somehow, you are still far from what you would consider rich. Imagine your surprise when you learn that not only did you not get the big tax cut you expected, but you are now “rich” and are actually subject to the alternative minimum tax. Ostensibly created as a means of keeping the rich from living tax-free, the alternative minimum tax is casting an ever-widening net each year as more taxpayers become subject to it.

This article will review the alternative minimum tax and explain the circumstances that expose an ever-larger number of taxpayers to this tax each year.

## THE AMT SYSTEM

The easiest way to understand the alternative minimum tax is to realize that it is a separate and distinct system from the “regular” income tax system. The tax under this system is based on modified rules for income, deductions, rates and schedules. The effects of these modified rules are generally three-fold: (1) the acceleration of income recognition, (2) the deceleration of certain expenses, and (3) the denial of certain deductions altogether.

The calculation of the alternative minimum tax basically takes your taxable income from Form 1040 and adds back certain deductions and exclusions to arrive at your “alternative minimum taxable income” (see Figure 1). The next step is to deduct the appropriate alternative minimum tax exemption amount. The tax is then calculated by applying the alternative minimum tax rates, shown in Table 1 on page 30 for 2001 (for married filing jointly taxpayers), to the net alternative minimum tax income that you calculated. You then compare your alternative minimum tax to your regular income tax and pay the higher of the two. Technically, the alternative minimum tax liability is the amount by which the alternative minimum tax exceeds the regular tax. This amount is entered on line 41 of Form 1040 and added to the regular tax.

## ADJUSTMENTS

The adjustments that are made in calculating the alternative minimum

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*Clark M. Blackman II, CPA/PFS, CFP, is managing director of Post Oak Capital Advisors, in Houston, Texas. Ellen J. Boling, CFP, is director of Private Client Advisors for Deloitte & Touche LLP in Cincinnati, Ohio.*

tax start with the taxpayer adding back their personal and dependent exemptions to their "regular" taxable income. For taxpayers who do not itemize, the standard deduction is also added back to income. For those who itemize their deductions, there are numerous adjustments to make, including the loss of deductions for all state, local, foreign-income, and property taxes.

Other lost deductions include investment expenses, employee business expenses, and certain medical and dental expenses. All of these 'add-backs' are considered exclusion items.

In addition to the lost deductions, certain income items are treated less favorably under the alternative minimum tax. For one, the income from private activity bonds issued

after August 7, 1986, which is normally tax-exempt, is fully taxable for alternative minimum tax purposes. A private activity bond is a municipal bond issued by a state or local government for the purpose of financing a private sector activity. They are typically used in conjunction with the construction of sports stadiums and arenas.

**INCENTIVE STOCK OPTIONS**

Another alternative minimum tax trap for the unwary employee is the treatment of incentive stock options. Under the regular income tax system there is no tax due at the exercise of an incentive stock option. Instead, tax is paid when you sell the shares, since the proceeds are considered capital gain income. In order to qualify for this treatment, the sale of shares can't take place prior to the two-year anniversary of the option's grant date, and you must hold the actual shares for at least one year after exercise. For most taxpayers, this is a small price to pay for the combination of tax deferral and capital gains treatment waiting at the end of the incentive stock option rainbow.

For alternative minimum tax purposes, however, the treatment of an incentive stock option exercise is much less favorable. Under the alternative minimum tax, the "spread" between the exercise date price and the grant price is treated as income.

For example, on April 30, 1999, Jim receives an incentive stock option giving him the right to purchase 1,000 shares of

**FIGURE 1. FORM 6251: ALTERNATIVE MINIMUM TAX**

Form <b>6251</b>		Alternative Minimum Tax—Individuals		OMB No. 1545-0227		
Department of the Treasury Internal Revenue Service (99)		See separate instructions.		2001		
Name(s) shown on Form 1040		Attach to Form 1040 or Form 1040NR.		Attachment Sequence No. <b>32</b>		
				Your social security number		
<b>Part I Alternative Minimum Taxable Income</b>						
1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6				1	
2	Medical and dental. Enter the <b>smaller</b> of Schedule A (Form 1040), line 4 or 2% of Form 1040, line 34				2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9				3	
4	Certain interest on a home mortgage <b>not</b> used to buy, build, or improve your home				4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26				5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21				6	( )
7	Investment interest. Enter difference between regular tax and AMT deduction				7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation				8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss				9	
10	Incentive stock options. Enter excess of AMT income over regular tax income				10	
11	Passive activities. Enter difference between AMT and regular tax income or loss				11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 9				12	
13	Tax-exempt interest income from private activity bonds issued after August 7, 1986				13	
14	Other. Enter the amount, if any, for each item below and enter the total on line 14.				14	
	a	Circulation expenditures				
	b	Depletion				
	c	Depreciation (pre-1987)				
	d	Installment sales				
	e	Intangible drilling costs				
	f	Large partnerships				
	g	Long-term contracts				
	h	Loss limitations				
	i	Mining costs				
	j	Patron's adjustment				
	k	Pollution control facilities				
	l	Research and experimental				
	m	Section 1202 exclusion				
	n	Tax shelter farm activities				
	o	Related adjustments				
15	Total adjustments and preferences. Combine lines 1 through 14				15	
16	Enter the amount from Form 1040, line 37. If less than zero, enter as a (loss)				16	
17	Enter as a positive amount any net operating loss deduction from Form 1040, line 21				17	
18	If Form 1040, line 34, is over \$132,950 (over \$66,475 if married filing separately) and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28				18	( )
19	Combine lines 15 through 18				19	
20	Alternative tax net operating loss deduction (see page 6 of the instructions)				20	
21	<b>Alternative minimum taxable income.</b> Subtract line 20 from line 19. (If married filing separately and line 21 is more than \$173,000, see page 7 of the instructions.)				21	
<b>Part II Alternative Minimum Tax</b>						
22	Exemption amount. (If this form is for a child under age 14, see page 7 of the instructions.)				22	
	<b>IF your filing status is . . .</b>		<b>AND line 21 is not over . . .</b>	<b>THEN enter on line 22 . . .</b>		
	Single or head of household . . . . .		\$112,500 . . . . .	\$35,750 . . . . .		
	Married filing jointly or qualifying widow(er) . . . . .		150,000 . . . . .	49,000 . . . . .		
	Married filing separately . . . . .		75,000 . . . . .	24,500 . . . . .		
	If line 21 is <b>over</b> the amount shown above for your filing status, see page 7 of the instructions.				23	
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 and stop here				23	
24	Go to Part III of Form 6251 to figure line 24 if you reported capital gain distributions directly on Form 1040, line 13, or you had a gain on both lines 16 and 17 of Schedule D (Form 1040) (as figured for the AMT, if necessary). <b>All others:</b> If line 23 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result				24	
25	Alternative minimum tax foreign tax credit (see page 7 of the instructions)				25	
26	Tentative minimum tax. Subtract line 25 from line 24				26	
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 43)				27	
28	<b>Alternative minimum tax.</b> Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 41				28	

**TABLE 1. CALCULATING THE ALTERNATIVE MINIMUM TAX**

Alternative Minimum Taxable Income					
Over	But Not Over	Pay	+	% on Excess	of the Amount Over
\$ 0	\$175,000	\$ 0	+	26 %	\$ 0
\$175,000	.....	\$45,500	+	28 %	\$175,000

Note: For 'married filing separately' filers, alternative minimum tax income figures are divided by 2.

his employer's stock at \$50 per share. On April 15, 2000, Jim exercises his option and pays \$50,000 ( $\$50 \times 1,000$  shares). At the time of this exercise, the stock was selling for \$100 a share. Jim then sells the shares on June 10, 2001, for \$120 per share.

Under regular income tax rules, Jim owes nothing in 1999 (the year of the grant), he owes nothing in 2000 (the year of exercise), and he owes capital gains tax on \$70 per share ( $\$120$  sale price less  $\$50$  basis price), or \$70,000 in 2001.

Applying the alternative minimum tax system gives us a very different result. Under alternative minimum tax, Jim again owes nothing in 1999 (the year of the grant). However, in 2000 (the year of exercise) Jim will have to recognize the spread of \$50,000, [ $\$100$  per share market value at time of exercise –  $\$50$  exercise price)  $\times$  1,000 shares] as income subject to the alternative minimum tax.

Assuming Jim owes alternative minimum tax as a result of the option exercise and is in the 26% the alternative minimum tax bracket (the alternative minimum tax is payable at either a 26% or 28% rate, depending on your income level), he will have to pay \$13,000 [26% of \$50,000] alternative minimum tax in 2000. In the subsequent year of sale, 2001, while Jim will have \$70,000, of regular capital gains income, he will reduce his income for alternative minimum tax purposes by \$70,000, since his basis in the stock for alternative minimum tax is \$100 per share (the alternative minimum tax stock basis is increased if alternative minimum tax is actually paid in the year of exercise).

## AMT CREDIT

The tax laws do offer some potential relief in the form of a minimum tax credit. The minimum tax credit is a credit allowed in future years against your regular tax liability for some of the taxes you paid under the alternative minimum tax rules. Not all alternative minimum tax paid is eligible to be recaptured with the minimum tax credit, but the tax you paid for exercising your incentive stock options is allowed. Alternative minimum tax paid as a result of the exclusion items described above is not eligible for crediting. Many taxpayers have exclusion items and they are the reason more folks are trapped by the alternative minimum tax.

For instance, in our previous example, Jim would be eligible to carry forward a \$13,000 minimum tax credit resulting from his alternative minimum tax payment in 2000. This credit may be used in future years against his regular tax liability. However, in any given year he may only use the minimum tax credit to offset the difference between his regular income tax liability and his alternative minimum tax liability. To illustrate this last point, let's assume that in 2001, Jim's regular income tax liability exceeds his calculated alternative minimum tax liability by \$5,000. Jim would be entitled to use \$5,000 of his minimum tax credit to offset

his 2001 regular tax liability. The remaining minimum tax credit of \$8,000 would then be carried over to future years.

As you can see, the process of recapturing your credit could take many years. This situation can be further exacerbated for those individuals with multiple years of incentive stock option grants who continue to incur alternative minimum tax liability each year in which they exercise an option. Remember, the longer the credit carries forward, the greater your opportunity cost. The tax credit is not indexed for inflation so you are being credited with "cheaper" dollars.

The story with incentive stock options sadly does not end there. In the past several years, many individuals have exercised incentive stock options, only to have the stock plummet in value. Yet they still have an alternative minimum tax obligation based on the price of the stock on the exercise date. In some extreme cases, especially in the technology industry, the tax is greater than the value of the shares when the tax is due!

Take the case of a technology executive who was granted 1,000 shares of stock with a strike price of \$50 per share. Assume for the sake of discussion that she is subject to alternative minimum tax at the 26% tax rate in the year she exercises the options. The stock is selling for \$100 at the time of exercise generating \$50,000 [ $1,000 \times (\$100 - \$50)$ ] of alternative minimum taxable income. By the end of the year the stock price has dropped 90%, to \$10 per share (unfortunately, this is a realistic example). Just like Jim in our earlier example, the executive

**TABLE 2. AMT EXEMPTION AMOUNTS FOR 2001**

Filing Status	AMT Exemption
Single	\$35,750
Married Filing Jointly	\$49,000
Married Filing Separately	\$24,500

would be subject to \$13,000 in taxes as a result of the exercise. Unfortunately, the shares she now has are only worth \$10,000! Strategies to potentially alleviate this problem do exist in many cases. However, that discussion is outside the scope of this article.

## EXEMPTIONS

The next step in the AMT process is to calculate the appropriate alternative minimum tax exemption amount. The exemption amount is subtracted from your alternative minimum tax income (just like a dependency exemption for regular taxes) to arrive at taxable income for alternative minimum tax. See lines 22 and 23 on Form 6251 (see Figure 1). The appropriate exemption amounts for 2001 are shown in Table 2. Be aware, however, that the exemption amount is reduced by 25 cents for every dollar of alternative minimum tax income that exceeds \$150,000 for married couples and \$112,500 for single taxpayers.

## THE GROWING REACH OF AMT

The alternative minimum tax, which originally was instituted to make sure the wealthy paid their fair share of taxes, has become an ever-growing issue that affects the tax returns of more and more individuals each year. In fact, when the alternative minimum tax was instituted, it affected less than 20,000 taxpayers annually. A recent congressional study revealed that currently over 600,000 taxpayers are affected. Other articles have stated that as many as five million taxpayers will be subject to the alternative minimum tax this year! What's more, current estimates are that unless changes are made to the system, over 36 million taxpayers will run afoul of the alternative minimum tax within the next decade! Are we really getting that rich, or are other forces at play?

The biggest culprit is merely a fact of life: inflation. Currently, many

aspects of the regular income tax system are indexed for inflation (exemptions, deduction limits, and even the tax brackets themselves). Meanwhile, the alternative minimum tax brackets and exemptions are not adjusted for inflation. The result is that many taxpayers find themselves victim to alternative minimum tax "bracket creep" each year.

Another factor is the growth in popularity of incentive stock options as a form of compensation. Not too long ago, incentive stock options were primarily reserved for the highest paid company executives. Throughout the 1990s many companies began offering this benefit to a broader employee base. In the high-tech industries, it was not uncommon to see practically every employee offered options as a means of retaining them in a very tight job market. While this trend has slowed along with the economy in the last few years, many of the options are now being exercised and thus exposing numerous taxpayers to the alternative minimum tax.

A third factor has to do with the federal budget. In an effort to slow the growth of government spending, the federal government is continually looking for ways to transfer the administration and costs associated with many programs down to the state level. Regardless of how one feels politically about this transfer, one outcome of this policy is increased demand for resources from state and local governments. These political institutions usually do not have the luxury of multi-decade budget deficits and therefore are much more prone to raising taxes to deal with these shortfalls. While each state and municipality deals with this issue in its own way, many of the solutions (i.e., income taxes, property taxes) are preference items (add-backs) in the alternative minimum tax system, and they therefore increase the likelihood that taxpayers in those jurisdictions will be subject to the alternative minimum tax.

Additionally, large amounts of

capital gain income could make a taxpayer liable for the alternative minimum tax. Since long-term capital gain tax rates (currently a maximum of 20%) are often lower than ordinary tax rates for many taxpayers, those who realize a substantial amount of these gains pay a lower percentage in taxes than those whose income is taxed at regular rates. This lower percentage can often make the taxpayer subject to alternative minimum tax.

Finally, the tax cuts enacted in 2001 will also throw some taxpayers into alternative minimum tax. As the scheduled decreases in the marginal tax rates are phased in, more taxpayers will pay less regular tax on the same income. Inevitably, a portion of those taxpayers will become subject to the alternative minimum tax.

One particularly onerous aspect of the alternative minimum tax is that you may be required to calculate and file the complex tax form, even if you are not subject to the tax in a given year. The reason is that certain aspects of the tax calculation carry forward from previous years and a return is required to establish those carry-forwards.

## CONCLUSIONS

The alternative minimum tax continues to cast an ever-widening net, ensnaring a larger portion of the middle class with each ensuing tax year. Taxpayers normally considered "middle" or "upper middle" class are becoming more susceptible each year. Especially vulnerable are:

- Those with large deductions due to state and local taxes;
- Those who exercise incentive stock options; and
- Those with a high number of dependent exemptions.

It is imperative that taxpayers in these situations understand which of their actions may exacerbate their tax situation. Taxpayers need to look at the alternative minimum tax consequences of actions such as accelerating deductions or realizing

long-term capital gains—commonly used practices to lower one’s income tax liability.

The reality is that many taxpayers are overlooking their need to file the Alternative Minimum Tax Form 6251 on a timely basis with their Form 1040. This exposes these unwitting lawbreakers to significant interest and penalties for underpay-

ment of tax should the IRS select their returns for audit. As we all know, “ignorance of the law is no excuse.”

The ultimate solution is to demand that Congress either repeal these complex rules or at the very least retroactively apply inflation indexing to the alternative minimum tax rates and exemptions. On the other

hand, you could always run for Congress. After all, you are rich, aren’t you?

We encourage you to consult with a professional tax advisor or financial planning advisor to understand the many ways you may be impacted by the alternative minimum tax before filing your next income tax return. ♦

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2/25/02

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